

Statement of the Northern California Power Agency
Before the House of Representatives
Committee on Government Reform
Subcommittee On Energy Policy, Natural Resources and Regulatory Affairs
Presented by George Fraser, General Manager
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Overview/Summary of Statement

- NCPA has heard that the Federal Energy Regulatory Commission's (FERC) Standard Market Design (SMD) is intended to encourage and facilitate voluntary bilateral contract arrangements. NCPA supports the idea of bilateral contracting, but the reality is that the California Independent System Operator's (CAISO) proposed Market Design 2002 (MD'02) will not accomplish that end.
- The process being used to develop MD'02 is not sufficiently open to address stakeholder concerns. Rather than addressing concerns, the process seems more focused on managing stakeholders while fast tracking a pre-ordained outcome. This must change if the trust needed for any market redesign to succeed is to be established.
- As currently envisioned, the market design is to be phased in with resource adequacy measures to follow. This is a serious case of putting the cart before the horse. Resource adequacy, most especially measures to address transmission constraints must be dealt with first. Any other approach simply institutionalizes existing inadequacies.
- In its current form MD'02 lacks sufficient detail concerning critical elements such as congestion management, market power mitigation and resource adequacy to allow an informed analysis of its potential to create incentive for investment in additional generation or transmission. In fact, NCPA sees *no* provision of the plan that addresses the critical inadequacy of the transmission system.
- NCPA is deeply concerned that California is getting out ahead of the rest of the Western Interconnect. Regional planning is essential to a durable, sustainable market.

Introduction

Good afternoon Mr. Chairman, members of the Subcommittee, my name is George Fraser, I am the General Manager of the Northern California Power Agency. NCPA is a nonprofit California joint powers agency established in 1968 to generate, transmit, and distribute electric power to and on behalf of its fourteen **members**: cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville, Santa Clara, Ukiah, the Port of Oakland, the Truckee Donner Public Utility District, and the Turlock Irrigation District; and four **associate members**, Bay Area Rapid Transit District, Lassen Municipal Utility District, Placer County Water Agency, and the Plumas-Sierra Rural Electric Cooperative. Our member communities serve nearly 700,000 electric consumers in central and northern California.

As participants in whatever market redesign may ultimately occur, NCPA members are understandably concerned about and very involved in the MD'02 and SMD processes. We have seen, and felt, firsthand the severe consumer and economic impacts that occur when market design efforts fail. For this reason, NCPA's members are grateful for this Subcommittee's continuing attention to this critical issue.

The results of the failed market design – soaring prices, decreased reliability, and questionable business practices that have cost Californians billions of dollars – must be in our minds as we move forward with any redesign. The experience of California in 2000-2001 and recent events in Texas¹ underscore the importance of getting market design right, and the enormity of the potential consequences of getting it wrong.

The touchstone for this process has to be benefit to the consumers of California. Any market design must increase efficiency and reliability. It must be workable and practical. For these reasons, NCPA believes that any market design must be modeled realistically and tested vigorously prior to implementation. Not merely tested by the CAISO and FERC, but also verified by independent parties and stakeholders.

MD'02 Is Inconsistent With SMD's Goal Of Encouraging Bilateral Contracts

Throughout this process we have heard time and again that SMD is being designed to encourage voluntary bilateral contracts. NCPA strongly favors voluntary bilateral contracts as a way of doing business. They are efficient, they allow parties to mitigate risk and produce terms appropriate to the entities involved.

The trouble is when we get into the details of MD'02 as proposed for California we see *nothing* that will facilitate or encourage this type of business arrangement. In fact, what we see is:

¹ According to a March 3, 2003 report from the Public Utility Commission of Texas' Market Oversight Division, peak market clearing prices frequently reached \$990/MWh, an 18-fold increase from the previous week, during the extreme weather event of February 24-26, 2003. The report notes that the price spikes appear to be the result of concerted efforts by some market participants to raise the clearing price artificially.

- A third party control operator running our generation.
- Insufficient durability in transmission rights to support long-term bilateral agreements.
- A central intermediary (middleman) with the result that all transactions are between buyer and intermediary, or seller and intermediary.

Under this type of structure, sellers and buyers are often unknown to one another. Accordingly, the only way to mitigate risk is to demand elevated credit assurances of all market participants. This, of course, inflates the market and drives higher prices to consumers. Further, every deal involves a third party and that party's costs. This too, will result in higher prices to consumers.

The proponents of SMD/MD'02 tell us that higher prices to consumers may be positive in the long term, in that it will send price signals that encourage development of new generation. The problem is that the added costs will not send price signals to generators, those signals will be lost at the intermediary. As a result, the plan will produce higher consumer cost, with no commensurate incentive to generators.

NCPA is prepared to support a plan that can be shown to encourage and facilitate voluntary bilateral agreements and long-term benefit to consumers. Until that plan is brought forward, in all of its component parts and in sufficient detail to allow complete analysis, NCPA will continue to advocate caution.

Stakeholder Process

Much has been said about the ongoing stakeholder process at CAISO. NCPA has been a participant in this process and very strongly believes that stakeholder involvement should be formalized. Specific lines of communication and a definitive commitment to a collaborative approach are essential to building confidence and trust in the process.

The details of any market design and all of its elements must be fully developed and communicated to stakeholders before implementation is commenced. The process must have real milestones and triggering events so that it does not appear that some aspects of the market design are being put in place even while stakeholder input is being asked for.

There must be a genuine commitment to the notion that the process will seriously consider stakeholder concerns and comments, and provide adequate responses as to how the comment is being incorporated or why it is not. This type of real consideration is essential to building trust and a feeling that stakeholder issues are being taken seriously.

To the extent that valid stakeholder concerns are ignored, rather than recognizably dealt with in the decisions, the resulting design will be unduly vulnerable to judicial challenge. That does not assure the stability that is needed for any market to work, nor does it engender confidence in stakeholders or in the public.

Finally, there should be neither implementation nor phase-in of any aspect until the entire market design has been vetted, tested, verified and subjected to third party scrutiny.

Sequencing

Implementation of any market design must be mindful of the risk of putting the cart before the horse. A market design that builds on lack of generation and, just as importantly, inadequate transmission capacity will be fundamentally flawed. Adequate generation capacity, including sufficient reserves will help deter the possibility of market participant withholding during critical times.

Just as important in California is the bottleneck effect of the current inadequate transmission system. For decades, California pursued a strategy of building generation facilities outside of the state and transmitting the power into the state to meet demand. This approach works only so long as the transmission system keeps pace with generation and load. Unfortunately it has not.

Particularly in the Northern California area, business decisions made in a regulated market led to a policy of "least cost planning" for transmission purposes, in which the tradeoff was assumed to be the additional cost of energy from inefficient generation in isolated load pockets vs. the total cost of new transmission. The practical effect was to produce a much less robust transmission system than exists elsewhere in the State, or in the West in general, and one that leads to high congestion problems.

With the first foray into deregulation of the market, a great deal of generation was sold to entities who believed they were entitled to bid any price the market could stand, and the "least cost planning" regime produced a "most cost operations" result. NCPA believes the addition of substantial additional transmission is probably even more important than additions of generation capacity, although both are necessary for the sort of market regime contemplated by either MD'02 or SMD to succeed.

Market Incentives And Resource Adequacy

It is difficult to assess the incentive or disincentive effect of MD'02 in light of the lack of specificity regarding mitigation and implementation of certain critical elements (e.g., LMP, CRR). NCPA has historically maintained the position that the LMP/CRR approach serves as a disincentive to investment – particularly in generation – because parties will not have the long-term transmission certainty critical to bilateral long-term power supply arrangements. Given the current state of affairs in the California energy market, we do not believe that MD'02 will result in substantial improvement to the transmission system.

As we noted above, any market design that does not address the generation and transmission capacity constraints simply institutionalizes the fundamental problems that underlie the problems seen in 2000-2001. As we learned, inadequate generation facilitates the possibility of withholding during critical times. Transmission bottlenecks create significant local market power situations. Both of these result in market

distortions, and deprive consumers of any benefits that might come from a well-designed competitive market.

Until local market power situations can be resolved, mitigation must be in place. The mitigation measures must be specific to the identified problem, and well-defined in advance of the implementation of the market design as a whole. Only when viewed as a package in its entirety can market participants and consumers make informed decisions about the design and its potential to produce real benefit to consumers.

Regional Solutions

It is essential that California not isolate itself from the western region. The fact is that generation, transmission and markets are regional in nature. Any market design that does not incorporate this reality into its fundamental structure will not be able to deliver on the promise of benefit to consumers.

As we have seen, when California's markets are more restrictive or less profitable, power flows away from the state causing inflated prices and reliability problems. Conversely, when the state's market is seen as freer or more lucrative, our neighbors suffer and the transmission inadequacies are exacerbated.

For very practical reasons, California cannot adopt a parochial approach, but must act in concert with those who depend on the western grid system. This regional approach will allow for maximum efficiency, reliability and consumer benefit. This broad based design also allows for maximum use of a wide array of environmentally benign generation sources.

Regional Monitoring/Mitigation

As we pointed out above, the market for electricity is inherently regional, rather than local, in nature. Of course, when transmission constraints become a factor, as they do in California, the market will break down into smaller regions (sometimes quite local in scale), in which a few generators may have significant market power.

Since State authority is required for most entities to condemn land for a transmission right of way (unlike the situation under the Natural Gas Act), and since additions to the transmission grid are a key part of the necessary solution, California will have to remain involved at some level, unless Congress chooses to give FERC the sort of right of way authority it has over gas transmission lines.

However, the mitigation rules and the monitoring mechanisms, have to work throughout the West, since experience has shown that the entire WECC (which is not synchronously connected with the remainder of the country) operates as a single market, and that entities can and will take advantage of different market rules to game the system. The experience of the 2000-2001 meltdown makes it clear to us, at least, that California cannot

effectively attempt to control the market by itself, and that a broader regional approach is needed.

In our view, the market monitoring and mitigation approaches have to be uniform throughout the West, but the actual monitoring has to be implemented on a more local level designed to catch and halt the exercise of market power in the smaller areas into which the market breaks down – at least pending the completion of needed transmission upgrades.

Open Access

NCPA as a transmission dependent utility cannot serve its member communities without open transmission access at some level. It is not surprising then, that we have a long history of support for the concept. It must be noted however, that for open access to produce real benefit, it must be implemented correctly in a transmission system with adequate capacity. Without adequate capacity, it cannot have a positive impact on reliability.

Conclusion

In light of recent events, the public's confidence in the ability of markets to provide efficient, reliable electric service has been badly shaken. It is therefore essential that any new market design:

- Be consistent with the stated goal of SMD regarding bilateral contracts;
- Come from a very open, public process;
- Be subjected to realistic modeling vigorous testing and verification;
- Demonstrate benefit to consumers;
- Include effective resource adequacy provisions addressing transmission and generation;
- Is understandable, practical and workable; and
- Receive buy-in from those who will have to live within its rules.

NCPA has demonstrated its willingness to participate in the process to develop a plan that meets these conditions. Once these conditions are met, NCPA stands ready to support implementation and fully participate in the plan.

Thank you, Mr. Chairman and members of the Subcommittee for your continuing attention to this critical issue.